McCrory Corporation

Annual Report 1973

To Our Stockholders:

Our annual report this year is considerably briefer than usual because we will be furnishing to you a proxy statement for the proposed merger of McCrory Corporation with a wholly-owned subsidiary of our parent company, Rapid-American Corporation. That proxy statement will contain additional financial information relating to each of the units of your company, as well as the terms and other information concerning the proposed merger.

Our annual meeting of stockholders, usually held on the fourth Tuesday in May, will be delayed and combined with a special meeting to permit us to submit the proposed merger to a vote of the stockholders. The date of the combined meeting will be announced as soon as possible.

The past year gave rise to important progress in our company. The merger of Lerner Stores Corporation with a subsidiary of McCrory was completed, thus achieving 100% ownership of Lerner common stock. The integration of J. J. Newberry Co.'s variety stores with our Variety Store Division was substantially completed.

Lerner Shops and OTASCO Stores reported continued improvement in earnings. These increases were offset in part by a decline in earnings of the Variety Store Division. That decrease was accounted for principally by the consolidation of J. J. Newberry Co. earnings for only the last five months of fiscal 1972.

Total earnings were substantially eliminated by the disappointing results of S. Klein Department Stores, Inc. In fiscal 1973 your company wrote off the $11.9 million of excess of cost of our investment in S. Klein over our equity therein. The write-off was considered necessary in view of significantly increased operating losses of S. Klein, which were approximately $9.6 million in fiscal 1973 before allocation of corporate financing and headquarters' administrative expenses and income taxes, compared to a corresponding loss of $3.4 million in the preceding year. Your management is developing a program the objective of which is to improve S. Klein's operating results. It is not presently possible to estimate what future losses, if any, might arise from S. Klein should such program not be successful.

Another major change in your company is currently the subject of negotiations. Your management has announced that it is negotiating for the transfer of our Variety Store Division, Britts Department Stores, Canadian Division and related corporate office assets to a new subsidiary of Interstate Stores, Inc. in exchange for shares of seven percent (7%) Preferred Stock of the subsidiary. The Preferred Stock will have a liquidation preference and redemption price equal to the carrying value of the net assets transferred, which is estimated to be $120-$125 million. McCrory will have an option to exchange that Preferred Stock for a like preferred stock of Interstate. The operations to be transferred had total assets of $245-$250 million at January 31, 1974, and accounted for approximately $640 million of $1.4 billion of sales for the fiscal year then ended. Net income of such operations for the year ended January 31, 1974 was approximately $9,000,000. At the date of this report agreement has not yet been reached on the terms of the transaction. Accordingly, it is not possible to predict whether the transaction will be consummated, or whether or not there will be further changes in its terms.

The proposed merger of McCrory with a wholly-owned subsidiary of Rapid-American is not conditioned on the consummation of the transaction with Interstate. The terms of the proposed merger, which have been approved in principle by the Boards of Directors of Rapid-American and McCrory are discussed in Note 20 to the accompanying financial statements.

Our thanks are extended for the patronage and support of our many customers, stockholders, employees, banks and suppliers during this past year.

Sincerely,

M. Riklis

MESHULAM RIKLIS,
Chairman of the Board

Stanley H. Kunsberg

STANLEY H. KUNSBERG,
President and Treasurer

April 30, 1974

Consolidated Statement of Income

	Year Ended January 31 1974	1973
	(In Thousands)	
Revenues:		
Sales	$1,424,018	$1,226,845
Other—net	4,647	3,143
	1,428,665	1,229,988
Costs and Expenses:		
Cost of goods sold	1,000,887	881,828
Selling, advertising, general and administrative expenses	346,604	268,470
Interest and debt expense	33,898	19,001
Depreciation and amortization	15,935	13,026
Federal income taxes (including deferred taxes of $5,015,000 and $1,677,000)	11,915	18,711
State income taxes	2,752	2,833
Income applicable to minority interest	3,166	8,606
	1,415,157	1,212,475
Income Before Write-off of Excess of Cost of Investment Over Related Equity	13,508	17,513
Write-off of excess of cost of investment over related equity (no tax effect)	11,907	—
Net Income	1,601	17,513
Consolidated preferred dividend requirements	1,160	959
Net Income Applicable to Common Stock	$ 441	$ 16,554
Earnings Per Share of Common Stock:		
Primary	$ .09	$4.15
Fully diluted	$ —	$2.89

See Notes to Consolidated Financial Statements.

Consolidated Balance Sheet

	January 31 1974	January 31 1973
	(In Thousands)	
ASSETS		
Current Assets:		
Cash (including certificates of deposit $185,000 and $26,130,000)	$ 8,814	$ 51,525
Receivables, less allowances ($2,558,000 and $2,068,000)	20,947	17,025
Merchandise inventories	257,424	236,475
Prepaid expenses, etc.	9,245	9,396
Total Current Assets	296,430	314,421
Investments in and Advances to:		
Rapid-American Corporation, at cost	3,621	3,621
McCrory Credit Corporation, at equity	15,358	14,369
	18,979	17,990
Property and Equipment:		
Furniture and fixtures and leasehold improvements	326,368	312,906
Store properties, warehouses and leased facilities	26,903	25,393
	353,271	338,299
Less accumulated depreciation and amortization	205,676	196,491
	147,595	141,808
Other Assets:		
Excess of cost of investments over related equities	61,795	20,627
Long-term receivable	6,628	7,132
Sundry	15,561	13,437
	83,984	41,196
	$546,988	$515,415

See Notes to Consolidated Financial Statements.

	January 31 1974	January 31 1973
	(In Thousands)	
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Bank loans	$ 24,326	$ 7,102
Current maturities of long-term debt	2,834	2,003
Accounts payable	71,256	70,018
Accrued expenses and sundry	54,011	51,141
Federal income taxes:		
Current	1,831	8,985
Deferred	9,645	8,929
Reserve for store closing programs	2,500	2,500
Total Current Liabilities	166,403	150,678
Long-Term Debt	258,961	186,863
Deferred Income Taxes	21,204	17,403
Reserve for Store Closing Programs	9,553	12,355
Other Long-Term Liabilities	9,747	9,356
Minority Interest in Subsidiaries	3,593	39,809
Stockholders' Equity:		
Preferred and preference stocks	15,712	15,744
Common stock, $.50 par value, authorized 15,000,000 shares	4,201	4,200
Additional paid-in capital	94,101	99,616
Retained earnings	74,128	100,250
Less common stock in treasury at cost and, in 1973, equity of $9,634,000 in subsidiary's cost of its treasury stock	(110,615)	(120,859)
	77,527	98,951
	$546,988	$515,415

See Notes to Consolidated Financial Statements.

Consolidated Statement of Stockholders' Equity

For the Two Years Ended January 31, 1974

	(In Thousands)						
	Preferred and Preference Stocks	**Common Stock Issued** Shares	**Common Stock Issued** Par Value	**Additional Paid-In Capital**	**Retained Earnings**	**Common Stock in Treasury** Shares	**Common Stock in Treasury** Cost
Balance February 1, 1972	**$15,754**	**7,279.6**	**$3,640**	**$76,918**	**$ 88,731**	**3,472.1**	**$121,162**
Add (Deduct):							
Common stock issued:							
Conversion of 103 shares of preferred stock	(10)	.5		10			
Exercise of 1,084,237 warrants		1,084.2	542	21,143			
Exercise of stock options					(358)	(31.3)	(1,036)
Conversion of $913,942 principal amount of 6½% convertible subordinated debentures, due 1992		35.5	18	849			
Acquisition of Newberry				(849)		(76.8)	(2,538)
Net income					17,513		
Dividends:							
Preferred and preference stock					(851)		
Common stock ($1.20 per share)					(4,672)		
Equity in certain transactions of subsidiaries				1,545	(109)		3,248
Other—net					(4)	.9	23
Balance January 31, 1973	**15,744**	**8,399.8**	**4,200**	**99,616**	**100,250**	**3,364.9**	**120,859**
Common stock issued:							
Conversion of 320 shares of preferred stock	(32)	1.6	1	31			
Exercise of stock options					(375)	(17.7)	(585)
Purchase of 1,600,485 warrants				(5,778)	(10,727)		
Net income					1,601		
Dividends:							
Preferred and preference stock					(850)		
Common stock ($1.20 per share)					(6,047)		
Equity in retirement of Lerner common stock in treasury				(97)	(9,409)		(9,506)
Equity in certain transactions of subsidiaries				331	(310)		(128)
Other—net		.6		(2)	(5)	(.6)	(25)
Balance January 31, 1974	**$15,712**	**8,402.0**	**$4,201**	**$94,101**	**$ 74,128**	**3,346.6**	**$110,615**

See Notes to Consolidated Financial Statements.

Consolidated Statement of Changes in Financial Position

	Year Ended January 31 1974	1973
	(In Thousands)	
Source of Funds		
Operations:		
Net income	$ 1,601	$ 17,513
Charges (credit) not requiring (providing) funds:		
Write-off of excess of cost of investment	11,907	—
Depreciation and amortization	15,935	13,026
Deferred income taxes	4,299	485
Debt expense	2,242	1,179
Stock bonus plan expense	629	633
Reduction of reserve for store closing programs as a result of reappraisal	(1,915)	—
Income applicable to minority interest, less cash dividends of $823,000 and $1,464,000	2,343	7,142
Total from operations	37,041	39,978
Debentures issued for Lerner minority interest	73,481	—
Property and equipment disposals	1,329	2,265
Acquisition of Newberry	—	51,274
Proceeds on exercise of options and warrants	552	23,165
Other—net	373	(243)
	$112,776	$116,439
Application of Funds		
Additions to property and equipment	$ 22,246	$ 19,751
Dividends paid	7,207	5,631
Acquisition of Lerner minority interest	92,416	5,534
Purchase of warrants	16,505	—
Payments of long-term debt	3,857	1,481
Deferred systems development costs	3,163	—
Reduction of deferred income taxes	498	7,703
Advance to McCrory Credit Corporation	600	1,000
Net non-current assets of Newberry acquired	—	116*
Increase (decrease) in working capital	(33,716)	75,223
	$112,776	$116,439
Increase (Decrease) In Working Capital by Components:		
Cash	$(42,711)	$ 22,944
Receivables—net	3,922	7,793
Merchandise inventories	20,949	105,114
Prepaid expenses, etc.	(151)	3,718
Bank loans	(17,224)	(7,102)
Current maturities of long-term debt	(831)	(1,547)
Accounts payable	(1,238)	(34,073)
Accrued expenses and sundry	(2,870)	(17,691)
Federal income taxes	6,438	(1,433)
Reserve for store closing programs	—	(2,500)
Increase (decrease) in working capital	$(33,716)	$ 75,223

** Assets of $33,401,000 (principally property and equipment—$25,511,000) less liabilities of $33,285,000 (principally long-term debt—$14,695,000 and reserve for store closing programs—$12,576,000)*

See Notes to Consolidated Financial Statements.

Consolidated Long-Term Debt

	Interest Rate Stated	Interest Rate Effective	January 31 1974 (In Thousands)	January 31 1973 (In Thousands)
Notes payable to banks under Revolving Credit Agreement(a)			$ 20,300	$ 20,300
Sinking fund notes, due 1976(b)	3¾%	3¾%	3,000	3,500
Sinking fund subordinated debentures, due 1976(c)	5½	6⁶⁄₁₀	11,357	11,357
Junior sinking fund subordinated debentures, due 1981(d)	5	5	11,106	11,810
Subordinated notes, payable $1,033,000 annually to 1981	5¼	5¼	7,236	8,269
Sinking fund subordinated debentures, due 1982(e)	6½	8⁷⁄₁₀	8,822	9,123
Sinking fund subordinated debentures, due 1985(f)	10½	11³⁄₁₀	11,239	11,831
Convertible subordinated debentures, due 1992(g)	6½	6⁹⁄₁₀	3,380	3,381
Sinking fund subordinated debentures, due 1994(h)	7½	9½	70,388	70,388
Convertible subordinated debentures, due 1994(i)	6½	6½	1,142	1,285
Sinking fund subordinated debentures, due 1995(j)	7¾	12¹⁄₁₀	115,152	—
Sinking fund subordinated debentures, due 1997(k)	7⅝	9⁸⁄₁₀	63,824	63,716
Sundry			1,731	2,081
			328,677	217,041
Less unamortized discount			69,716	30,178
			$258,961	$186,863

(a) 90 day promissory notes with interest at current prime rate (9½% at January 31, 1974) renewable at the option of McCrory at each maturity date to June 30, 1975. It is McCrory's present intention to renew these notes until June 30, 1975.

(b) Sinking fund payments in the amount of $500,000 required annually through 1975 with the balance of $2,500,000 payable May 15, 1976.

(c) All sinking fund requirements have been met.

(d) Exclusive of $718,000 and $274,000 at January 31, 1974 and 1973, respectively, which have been reacquired and are available for sinking fund payments. Annual sinking fund requirements are $649,000 commencing in 1975.

(e) Sinking fund requirements in each year based on original principal amount ($10,025,000) are as follows: 1974-1976 (3%), 1977-1979 (4%), and 1980-1981 (5%).

(f) Sinking fund payments in the amount of $592,000 required annually commencing in 1974.

(g) Convertible into McCrory common stock at the option of the holder at the conversion price of $30 principal amount of debentures per share to and including February 14, 1977 and $35 thereafter.

(h) Required annual sinking fund payments commence in 1981.

(i) Convertible into Newberry common stock at the option of the holder at the conversion price of $30 principal amount of debentures per share.

(j) Sinking fund requirements in each year based on original principal amount ($130,211,000) are as follows: 1974-1979 (3%), 1980-1983 (4%), 1984-1989 (5%) and 1990-1995 (6%).

(k) Required annual sinking fund payments commence in 1984.

Notes to Consolidated Financial Statements

(1) Accounting Policies

Significant accounting policies of McCrory are as follows:

The accounts of all subsidiaries except McCrory Credit Corporation, which is carried on the equity basis, are included in the consolidated financial statements. Accounts of Canadian subsidiaries (which are not significant in relation to the accompanying statements) are translated at appropriate exchange rates.

Inventories are stated at the lower of cost (principally retail method) or market.

Property and equipment is stated at cost. Depreciation and amortization is computed generally on the straight-line method based on the estimated service lives of the assets.

The excess of cost of investments over related equities which arose from acquisitions prior to October 31, 1970 ($8,720,000 at January 31, 1974 exclusive of excess cost applicable to investment in S. Klein Department Stores, Inc.—See Note 6) has been recognized as being similar in nature to intangibles which have not declined in value since acquisition. In accordance with Accounting Research Bulletin 43, these excess costs are not amortized so long as there is no diminution in value of the related investments.

The excess of cost of investments over related equities which arose from acquisitions subsequent to October 31, 1970 ($53,075,000, after amortization, at January 31, 1974) is being amortized on a straight-line basis over forty years. (See Note 5).

The flow-through method of accounting is used for investment tax credits.

The companies provide for and fund pension costs each year in an amount equivalent to the actuarially computed current service cost plus amortization of past service cost over a period not exceeding 30 years.

(2) Accounts Receivable and McCrory Credit Corporation

McCrory and some of its affiliates have agreements with McCrory Credit Corporation under which certain customers' accounts receivable are assigned to McCrory Credit and McCrory Credit remits amounts equal to 90% of the amounts assigned, withholding 10% of the uncollected balances, representing the companies' equity therein. Under the agreements, the companies accept reassignment of any accounts in default. The 10% equity of McCrory and subsidiaries in assigned accounts receivable (the uncollected accounts receivable balances amount to $74,347,000 and $66,447,000 at January 31, 1974 and 1973, respectively) is included in receivables in the consolidated balance sheet. Collections in January (payable to McCrory Credit in February) from assigned customers' accounts (net of 10% equity) amounting to $17,391,000 and $15,629,000, respectively, have been deducted from receivables in the consolidated balance sheet. McCrory Credit's condensed consolidated balance sheet at January 31, 1974 is presented below:

	(In Thousands)
Accounts receivable, less unearned discount	$84,920
Cash	13,388
	$98,308
Notes payable to banks	$81,500
Subordinated note payable to Rapid-American Corporation	1,000
Other liabilities, less other assets	450
McCrory's equity (including $9,600,000 subordinated notes payable)	15,358
	$98,308

Net income of McCrory Credit for the years ended January 31, 1974 and 1973 of $389,000 and $511,000, respectively, is included in consolidated net income.

McCrory Credit has no formal agreements which restrict the use of its cash balances. However, it is expected, under various informal arrangements, to maintain compensating balances under certain of its lines of credit. Such compensating balances in the aggregate comprise a principal portion of cash as reflected in the above condensed consolidated balance sheet.

A subsidiary of McCrory has financing arrangements totaling $15,000,000, under which customers' accounts receivable are assigned (with recourse) to two banks. The banks remit 90% of the balances assigned; the remaining 10% represents the subsidiary's equity therein.

(3) Merchandise Inventories

	1974	1973
	(In Thousands)	
Merchandise at stores and warehouses:		
At retail method	$175,709	$166,556
At first-in, first-out cost	40,495	33,953
Merchandise in transit, at warehouses and at restaurants—at identified cost	41,220	35,966
	$257,424	$236,475

(4) J. J. Newberry Co.

As of September 1, 1972, through the merger of its wholly-owned subsidiary with J. J. Newberry Co., McCrory acquired all of the then outstanding common stock of Newberry for an aggregate purchase price of $51,274,000, consisting of 76,792 shares of McCrory common stock and $63,716,000 principal amount (discounted value $49,485,000) of new McCrory 7⅝% sinking fund subordinated debentures due December 15, 1997. This acquisition has been accounted for as a purchase transaction. Accordingly, Newberry's accounts are included in the consolidated financial statements from the date of acquisition (See Note 10).

McCrory's cost of its investment in Newberry was $23,262,000 less than Newberry's net tangible assets at date of acquisition, which amount was attributed entirely to Newberry's property and equipment and is being amortized (as a reduction of depreciation) over the estimated remaining useful life of 10 years from September 1, 1972. Such amortization amounted to $965,000 during the five months ended January 31, 1973 and $2,326,000 during the year ended January 31, 1974.

(5) Lerner Stores Corporation

At January 31, 1973 McCrory owned 60% of the outstanding capital stock of Lerner Stores Corporation. On September 18, 1973 (accounted for as of August 1, 1973), a wholly-owned subsidiary of McCrory was merged with Lerner. In connection with the merger, which was accounted for as a purchase transaction in which McCrory was the acquiring corporation: (a) $113,668,000 principal amount (discounted value $72,534,000) of McCrory 7¾% sinking fund subordinated debentures due in 1995 and $18,194,000 in cash were exchanged for all of the outstanding shares of Lerner common stock and substantially all of the outstanding Lerner common stock purchase warrants; and (b) the Lerner common treasury stock was cancelled. In addition, $1,484,000 principal amount (discounted value $947,000) of such debentures were issued upon exercise of Lerner warrants. The aggregate cost of McCrory's investment in Lerner exceeded its equity in the underlying net assets at dates of acquisition by $61,795,000 (after amortization of $672,000) at January 31, 1974 and $8,720,000 at January 31, 1973.

Lerner, in a private purchase in June 1972, acquired 59,100 shares of its common stock at $44 per share and during August 1972 acquired in a cash tender offer 68,614 shares of its common stock at $42 per share.

(6) S. Klein Department Stores, Inc.

During the year ended January 31, 1974, S. Klein Department Stores, Inc., a wholly-owned subsidiary of McCrory, incurred an operating loss of approximately $9,600,000 before allocation of corporate financing and headquarters' administrative expenses and income taxes, compared to a corresponding operating loss of approximately $3,400,000 for the year ended January 31, 1973. As a result, management concluded that the excess ($11,907,000) of the cost of its investment in S. Klein at date of acquisition over the related equity no longer had value and wrote off such excess cost as of January 31, 1974.

At January 31, 1974, McCrory's investment in and advances to S. Klein was approximately $31,000,000 and the aggregate lease commitments (under leases expiring at various dates to 2002) of S. Klein, substantially all of which are guaranteed by McCrory, were approximately $157,000,000, with minimum annual rentals of approximately $8,700,000. McCrory is guarantor of substantially all of S. Klein's trade payables, which amounted to approximately $10,300,000 at January 31, 1974. Management intends to continue to operate S. Klein and is developing a program the objective of which will be to improve S. Klein's operating results. It is not presently possible to determine what future losses, if any, might arise from S. Klein should such program not be successful, and no provision for such losses has been made in the accompanying financial statements.

(7) Rapid-American Corporation (Parent Company)

McCrory owned at January 31, 1974, 77,684 shares of Rapid-American Corporation common stock and 155,368 redeemable warrants (expiring May 15, 1994) to purchase Rapid common stock at $35 per share. The common stock and warrants had an aggregate market quotation value of $1,942,000 at January 31, 1974. (See Note 20).

(8) Long-Term Receivable

McCrory is to receive $593,000 per year in payment of the long-term receivable aggregating $11,329,000, which was discounted at an interest rate of 5% per annum.

(9) Long-Term Debt

The aggregate of long-term debt (see accompanying schedule) maturing during the five years ending January 31, 1979 is approximately as follows: 1975, $2,834,000 (included in current liabilities); 1976, $23,409,000; 1977, $17,132,000; 1978, $3,324,000; and 1979, $6,638,000. The year 1976 includes $20,300,000 of notes payable to banks under the Revolving Credit Agreement.

Agreements covering certain indebtedness of McCrory contain covenants concerning working capital, additional indebtedness, limitations on the declaration and payment of dividends, restrictions on transactions in capital stock, etc. At January 31, 1974, approximately $8,800,000 of retained earnings was free of such restrictions. Also, consolidated current assets as defined must be at least 175% of consolidated current liabilities at each fiscal year-end.

(10) Significant Additional Income Statement Information

Selling, advertising, general and administrative expenses include the following:

	Year Ended January 31, 1974	1973
	(In Thousands)	
Severance pay to former chief executive officer (net of reserves)	$1,421	—
Charge for estimated costs in connection with possible sale of certain divisions (See Note 20)	$1,500	—
Credit resulting from reduction of reserve for store closing programs as a result of reappraisal (See Note 12)	$(1,915)	—
Loss on closing of Newberry's corporate headquarters	—	$1,022

Costs of $3,163,000 incurred in the year ended January 31, 1974 in converting Newberry to the McCrory system of buying, merchandising and traffic control and developing a new warehousing and traffic system, have been classified as deferred systems development costs (included in sundry assets at January 31, 1974) and will be amortized over five years.

Newberry's operations, which are included in the accompanying financial statements from September 1, 1972, are seasonal with all profits normally occurring in the last portion of the year. If pro forma effect were given to the acquisition of Newberry as if it took place on February 1, 1972, consolidated sales for the year ended January 31, 1973 would have been approximately $215,000,000 greater and net income for such year would have been approximately $2,100,000 ($.42 per share on a fully diluted basis) less after giving effect to a $520,000 pre-acquisition credit (net of tax effect) from reappraisal of the reserve for store closing programs (See Note 12).

(See also Note 13 regarding pension costs).

(11) Federal Income Taxes

For Federal income tax purposes guideline methods of computing depreciation and the installment method of reporting certain sales and carrying charges thereon have been used. The use of these methods has resulted in tax deferments which have been charged against income and credited to deferred income taxes payable, of which the portion relating to installment sales has been included in current liabilities.

Deferred tax expense results from timing differences in the recognition of revenue and expense for tax and financial statement purposes. The sources of these differences in the year ended January 31, 1974 and the tax effect of each were as follows:

	(In Thousands)
Excess of tax over book depreciation	$2,150
Use of installment method of reporting certain sales for income tax purposes	716
Reduction in reserve for store closing programs	1,340
Deferred systems development costs	1,440
Other items	(631)
	$5,015

The following is a reconciliation of the provision for Federal income taxes for the year ended January 31, 1974 using the applicable statutory tax rate, with the Federal income tax expense shown in the consolidated statement of income:

	(In Thousands)
Income before Federal income taxes, minority interest and write-off of excess of cost of investment over related equity	$28,589
Federal income tax provision computed at statutory rate	$13,723
Increase (reduction) in Federal income taxes resulting from:	
Amortization of excess of equity over cost of related investment not taxable	(1,117)
Amortization of excess of cost of investment over related equity not deductible for tax purposes	323
Investment tax credit	(949)
Other	(65)
	$11,915

Investment tax credits of $949,000 and $784,000 in the years ended January 31, 1974 and 1973, respectively, were applied as reductions of the current tax provisions.

Certain Canadian subsidiaries have net operating loss carryforwards approximating $1,400,000 which will expire in the year ending January 31, 1976. The tax benefits of such loss carryforwards will be recognized when realized.

(12) Reserve for Store Closing Programs

The reserve for store closing programs represents estimated losses, including payments under existing leases (less estimated subrental income), as determined by Newberry prior to the date of acquisition, in connection with its programs to close certain unprofitable stores. Such losses applicable to closed stores (insignificant during the period from September 1, 1972 to January 31, 1973, and $887,000 for the year ended January 31, 1974) are charged against the reserve as incurred. As a result of periodic reappraisals by management, the reserve was reduced by $1,000,000 on August 31, 1972 (prior to the date of acquisition) and by $1,915,000 (credited to selling, advertising, general and administrative expenses) in January 1974.

All store operations are included in the consolidated statement of income until the stores are closed. It is estimated that the programs covered by this reserve will be completed over the next four years.

(13) Pension Plans

McCrory and its subsidiaries have several pension plans, one of which is contributory, covering certain of their employees. For the years ended January 31, 1974 and 1973 pension costs amounted to $1,901,000 and $1,632,000, respectively. During the year ended January 31, 1974 the actuarial investment rate assumption used in computing pension cost was changed, resulting in a decrease in pension cost of approximately $650,000. Unfunded past service costs amounted to approximately $4,928,000 at January 31, 1974. Management of McCrory is considering the combination of Newberry's pension plan with that of McCrory.

(14) Preferred and Preference Stock and Common Stock Purchase Warrants

At January 31, 1974, 157,119 shares of $100 par value preferred and preference stock were outstanding (aggregate par value $15,712,000; aggregate redemption amount $17,137,000), as follows:

	Shares				
Class of Stock	Authorized	Outstanding	Redemption Price	Conversion Rate	Common Shares Reserved
3½% preferred	1,139	1,139	$104	5 for 1	5,695
$6 preference	94,725	94,725	115	3/14 for 1	20,298
5½% preference B	1,824	1,292	100	—	—
4½% preference B	60,201	59,963	100	—	—
		157,119			25,993

At January 31, 1974 there were outstanding warrants (expiring March 15, 1976) to purchase 74,905 McCrory common shares at $20 per share; warrants (expiring March 15, 1981) to purchase 471,997 McCrory common shares at $20 per share through March 15, 1976 and thereafter at $22.50 per share; and warrants (expiring October 1, 1981) to purchase 122,824 McCrory common shares at $65.64 per share.

(15) Stock Option and Stock Bonus Plans

The following summarizes the common stock option activity for the year ended January 31, 1974:

	1964 Plan	1967 Plan	Other*
Option price range	$18.50	$16.50-32.625	$11.83-20.71
		Shares	
Outstanding February 1, 1973	—	20,525	—
Transactions during the year:			
Granted	21,400	—	131,241
Exercised	—	—	(17,697)
Cancelled	—	(9,900)	(23,630)
Outstanding January 31, 1974	21,400	10,625	89,914
Additional shares available for granting of options at January 31, 1974	146,485	103,129	—

* Substituted for outstanding options granted under Lerner stock option plans.

At January 31, 1974, 56,137 McCrory shares were available for allocation under stock bonus plans. The excess of market value of such shares on the date of allocation over the par value thereof is being charged to income ratably over periods not exceeding eight years from date of issuance.

(16) Earnings Per Share of Common Stock

Primary earnings per share is based on the weighted average number of common shares outstanding during each year. Fully diluted earnings per share has been computed assuming conversion

of all convertible securities when the effect would be dilutive. This calculation also assumes the issuance of additional common shares on exercise of stock options and warrants with a portion of the proceeds used to acquire common stock and the balance used to reduce outstanding debt.

(17) Compensating Balances

McCrory has a revolving credit agreement with five banks aggregating $70,000,000 which is utilized to meet cash requirements as necessary. Under this agreement, McCrory borrows money evidenced by 90 day promissory notes with interest payable at the prime rate. In addition, a commitment fee of ½% per annum of the average daily unused amount is payable to the banks. At January 31, 1974 there was $20,300,000 of such notes outstanding, which are renewable at McCrory's option to June 30, 1975. It is McCrory's present intention to renew these notes until June 30, 1975 (see Note 9). During the year ended January 31, 1974, the maximum and average borrowings outstanding were $70,000,000 and $47,700,000, respectively. The interest rate applicable to fiscal 1973 loans ranged from 6 to 10% and the weighted average interest rate during the year was 8.7%.

In addition, certain consolidated subsidiaries of McCrory have lines of credit totaling $57,700,000 with banks on a short-term basis which are utilized to meet cash requirements as necessary. During the year ended January 31, 1974, the maximum and average borrowings outstanding were $45,535,000 and $25,900,000, respectively. The interest rate applicable to fiscal 1973 loans ranged from 6 to 10% and the weighted average interest rate during the year was 8.9%.

In connection with certain of these loans, informal arrangements required maintenance of compensating balances averaging 20% of the bank loans outstanding and 10% of certain portions of the unused credit lines.

There are no legal restrictions on the withdrawal of such funds.

(18) Lease Commitments

McCrory operates principally in leased premises. The basic terms of the leases generally range from 10 to 30 years and provide for the payment of additional rentals based upon percentages of sales, plus in certain instances, real estate taxes, insurance and maintenance. Many of the leases meet the criteria of non-capitalized financing leases as defined by the Securities and Exchange Commission.

Rent expense, net of minor sublease income, is as follows:

	Year Ended January 31	
	1974	1973*
	(In Thousands)	
Basic rents:		
Non-capitalized financing leases	$31,784	$23,772
Other	39,722	29,429
Contingent rents	9,515	8,126
Total	$81,021	$61,327

* J. J. Newberry Co. is included from date of acquisition, September 1, 1972.

The minimum rental commitments, net of minor sublease income, in effect at January 31, 1974 are as follows:

Periods Ending January 31	Financing Leases	Total
	(In Thousands)	
1975	$ 31,784	$ 63,708
1976	31,228	61,595
1977	30,382	59,107
1978	29,817	56,107
1979	29,235	53,594
1980-1984	132,485	231,674
1985-1989	89,326	153,272
1990-1994	52,132	83,177
Thereafter	49,897	56,431
Total	$476,286	$818,665

Total minimum rental commitments, present values of non-capitalized financing lease commitments, and the weighted average and range of interest rates used in computing present values of financing lease commitments are as follows:

	January 31, 1974		
	Real Property	Equipment and Fixtures	Total
	(In Thousands)		
Total minimum rental commitments	$797,129	$21,536	$818,665
Total non-capitalized financing lease commitments	455,553	20,733	476,286
Present values of non-capitalized financing lease commitments	260,066(a)	16,129	276,195
Range of interest rates used in computing present values	3.5% to 10.5	5.0% to 6.5	3.5% to 10.5
Weighted average interest rates used in computing present values	6.1	6.0	6.1

	January 31, 1973		
	Real Property	Equipment and Fixtures	Total
	(In Thousands)		
Total minimum rental commitments	$830,778	$25,322	$856,100
Total non-capitalized financing lease commitments	484,246	24,488	508,734
Present values of non-capitalized financing lease commitments	271,896(a)	18,751	290,647
Range of interest rates used in computing present values	3.5% to 10.5	5.0% to 6.5	3.5% to 10.5
Weighted average interest rates used in computing present values	6.1	6.0	6.1

(a) Determination of real estate taxes was impracticable.

If all leases identified as non-capitalized financing leases had been capitalized, the effect on net income would have been as follows:

	Year Ended January 31	
	1974	1973*
	(In Thousands)	
Increase in amortization expense	$ 15,616	$ 11,351
Increase in interest expense	17,661	14,122
Decrease in lease rental expense	(32,293)	(24,369)
Net increase in expense	984	1,104
Decrease in income tax provision	472	529
Decrease in net income	$ 512	$ 575

* J. J. Newberry Co. is included from date of acquisition, September 1, 1972.

(19) Other Commitments and Contingencies

There are claims pending against McCrory and its subsidiaries. Management, based upon opinions of counsel, is of the opinion that the ultimate liability, if any, will not materially affect the business or the consolidated financial position of McCrory and its subsidiaries. (See Note 18).

(20) Other Significant Events

McCrory is engaged in negotiations for the transfer of its Variety Store Division, Britts Department Stores, and Canadian Division, together with related corporate office assets, to a newly organized subsidiary of Interstate Stores, Inc. in exchange for a new issue of 7% preferred stock of the subsidiary. The preferred stock will have a liquidation preference and redemption price equal to the recorded value of the net assets to be transferred. McCrory is to have an option to exchange the subsidiary's preferred stock for a like preferred stock of Interstate. During the period after execution of an agreement and prior to final consummation of the transaction, McCrory is to guarantee a portion of a $30,000,000 interim bank credit to Interstate's toy and department store operations. At January 31, 1974 the total assets proposed to be transferred were between $245,000,000 and $250,000,000, and the net assets proposed to be transferred were between $120,000,000 and $125,000,000. Sales and net income of the operations to be transferred for the year ended January 31, 1974 were approximately $640,000,000 and $9,000,000, respectively. At the present time, it is uncertain as to whether this transaction will be consummated or whether or not there will be further changes in the terms of this transaction.

On January 29, 1974 McCrory and Rapid-American Corporation (which on that date held 62.3% of the common stock of McCrory), announced an agreement in principle for a merger whereby McCrory is to become a wholly-owned subsidiary of Rapid. McCrory common stockholders (other than Rapid) are to receive one share of a new Rapid $1.50 convertible preferred stock ("Rapid Preferred Stock") for each share of McCrory common stock held and, in addition, will have the option to tender shares of Rapid Preferred Stock for $18 per share in cash for a short period after the merger. The McCrory 3½% Cumulative Convertible Preferred Stock and the 5½% Cumulative Preference B Stock Series are to be redeemed. The McCrory $6 Cumulative Convertible Preference Stock will continue to be an outstanding security of McCrory but will be convertible into shares of Rapid Preferred Stock rather than into shares of McCrory common stock. The McCrory 6½% Convertible Subordinated Debentures due in 1992 will become convertible into shares of Rapid Preferred Stock rather than into shares of McCrory common stock. Each McCrory common stock purchase warrant expiring in March 1976 and March 1981 will be exercisable for one share of Rapid Preferred Stock rather than into shares of McCrory common stock and may be tendered for $6 in cash per warrant during a short period after the merger. The 4½% Cumulative Preference B Stock of McCrory will continue as an outstanding security of McCrory, and existing McCrory debentures will continue to be debt of McCrory. The merger is subject to a number of conditions including the execution of a definitive agreement between the parties and obtaining requisite approval from stockholders of Rapid and McCrory.

HASKINS & SELLS
CERTIFIED PUBLIC ACCOUNTANTS

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ACCOUNTANTS' OPINION

The Board of Directors and Stockholders of
McCrory Corporation:

We have examined the consolidated balance sheet of McCrory Corporation and subsidiary companies as of January 31, 1974 and 1973 and the related statements of income, stockholders' equity, and changes in financial position for the years then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of Lerner Stores Corporation (a consolidated subsidiary) and its subsidiaries, which statements reflect total assets constituting 26% and 28%, respectively, of consolidated total assets at January 31, 1974 and 1973, and revenues constituting 33% and 35%, respectively, of consolidated revenues for the years then ended. These statements were examined by other auditors whose report thereon has been furnished to us and our opinion expressed herein, insofar as it relates to the amounts included for Lerner Stores Corporation and its subsidiaries, is based solely upon the report of the other auditors.

In our opinion, subject to the effect of the resolution of the S. Klein Department Stores, Inc. matter described in Note 6 and based upon our examination and the report of other auditors referred to above, such consolidated financial statements of McCrory Corporation present fairly the financial position of McCrory Corporation and subsidiary companies at January 31, 1974 and 1973 and the results of their operations and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied.

Haskins & Sells

April 24, 1974

EXECUTIVE OFFICES

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